

**IMPACT OF VENTURE CAPITAL IN THE DEVELOPMENT OF  
ZANZIBAR SMEs**

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**CERTIFICATION**

The undersigned certifies that he has read and hereby recommend for acceptance of the work titled “Impact of Venture Capital to the Development of Zanzibar SMEs” by the Open University of Tanzania (OUT), as fulfilment of the requirements for the Master of Business Administration (MBA) Executive Programme.

.....

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.....

Date

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**I, Husna Ahmed Mohammed**, do hereby declare that this dissertation is my own work and has not been submitted at any level of study in any of the higher learning institutions.

.....

Signature

.....

Date

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**DEDICATION**

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## **ABSTRACT**

Venture capital has a significant impact on Small and Medium Enterprises (SMEs). In Zanzibar Isles, small businesses have been and are the stepping stone of industrialization in Isles. The purpose of this study was to find out the impact of venture capital on growth of SMEs in Zanzibar. The lack of finance has been cited as a major contributor to SMEs failure in Zanzibar Urban West Region. Despite the lack of Venture Capital Organization in Zanzibar Urban West Region, Venture capital is the best source of business finance. The methodology used interview guide and the data was collected, coded, quantified and analyzed quantitative and qualitatively. Quantitative data was analysed with the use of statistical package for social science (SPSS). The findings in this study revealed that venture capital has an impact on growth of SMEs. The study has demonstrated that use of venture capital can improve SMEs and hence strengthen Zanzibar Economy. The study concluded that countries that use venture capital experience improved economic growth and thus Zanzibar should follow that experience by promoting the establishments of Venture Capital Organizations, and also SME's of Zanzibar should be encouraged to use this form of finance to achieve their economic growth.



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## ABBREVIATIONS

AEAF	Association of East Africa Fund
AWAF	Association of West Africa Fund
BDG	Business Development Gateway
BOT	Bank of Tanzania
BPC	Business Plan Competition
CoC	Cash-on-Cash
EIB	European Investment Bank
GDP	Gross Domestic Product
IPO	Initial Public Offering
IRR	Internal Rate of Return
MSME	Micro Small and Medium Enterprises
NOK	Norwegian Kroner
NORFUND	Venture Capital Fund
NPV	Net Present Value
NVCAIO	National Venture Capital Association of Industry Overview
PPP	Private Public Partnership
R&D	Research and Development
ROI	Return on Investment
SMEs	Small and Medium Enterprises
SMEEIS	Small and Medium Enterprise Equity Investment Scheme
SRS	Simple Random Sampling
TPSF	Tanzania Private Sector Foundation
USA	United States of America

VC	Venture Capital
ZATI	Zanzibar Association of Tourism Investors
ZIFA	Zanzibar Institute of Financial Administration
ZNCCIA	Zanzibar National Chamber of Commerce, Industry and Agriculture



## **CHAPTER ONE**

### **1.0 INTRODUCTION**

#### **1.1 Background to the Study**

In most developing countries, particularly in Africa, it is difficult to bring together the finance required to start or develop an enterprise UNIDO (2001). Normally, it is the large scale investments that enjoy attention of local and International Finance Institutions and therefore have a chance to develop.

These local and international financial organizations hardly manifest keen interest in financing small and medium investments and as such most of such investments have been struggling for their survival. Zanzibar is not exceptional to this situation as it has seen frequent scenario of its SMEs. Most of the SMEs in Zanzibar are seriously facing the problem of capital, which limits their chance to grow.

It is argued that SME's play a major role in socio-economic development in Zanzibar and many other countries. This is apparent in Zanzibar where SME's contribute significantly to job creation, income generation and stimulation of economic growth.

The Governments of Zanzibar and the United Republic of Tanzania, being motivated by the role of SMEs in fighting unemployment, which is rampant in most African countries Tanzania inclusive, have been taking initiatives towards empowering the SMEs within the country through different strategies. Despite these government initiatives to support SMEs in Zanzibar, these SMEs are facing stiff challenges in growing mainly due to the scarcity of resources accessible to support them.

The share of private sector employment and SMEs in specific has been growing since economic liberalization policy became operational in the country in mid-1980. The SMEs

is now contributing about a third of GDP and creating more employment. The challenge is to promote a sustainable industrial sector driven by the development of SMEs with a view to accelerate economic growth and reduce poverty through income generation and job creation.

In terms of ownership, structure of SMEs as reported by the Bank of Tanzania (BOT) Zanzibar (2009), revealed that simple forms of business ownership is dominant, accounting for 43.9% of the SMEs, followed by company ownership accounting for 26.8% while partnership and cooperatives were the least forms of ownership, accounting for 20.7% and 8.5% respectively. According to Ministry of Trade Industry and Marketing most SMEs are organized as cooperate and Industry RGoZ (2004). Zanzibar Business Census showed that there were 15,192 informal sector operators employing 67,526 persons, of which Urban West Zanzibar Statistics show that the majority of activities are concentrated in trade; wholesale and retail business (65%), followed by manufacturing (12%) and hotel and restaurants attracted only 8 % of business activities, MSMEs engage about 4 % in community and personal services while other sector attracted only 11 %. The findings observed that significant proportion of SMEs. Most of SMEs workers are working on temporary basis and thus their employment is unstable and that workers are highly vulnerable to socio-economic shocks and therefore highly exposed to poverty.

Considering that scenario, one of the most significant opportunities for the Zanzibar SMEs to develop is through venture capital approach. It is worthwhile to briefly define what is venture capital. Though it is agreed that there is no single acceptable definition of this terminology, it can be simply be defined as equity financing to the young enterprises.

Venture Capital (VC) is vital in fortifying innovative activity and entrepreneurial talent and serves as an important tool for overcoming some of the inherent barriers to growth caused by prevailing industrial and institutional structures. The role of Venture Capitalists is to provide financing to new often high risk ventures by pooling funds from various sources and invest them and actively participate in running the firm by providing support to the firms with their prior experiences and general expertise.

Venture capital also plays significant role in improving the performance of the relevant company through relatively easy access to finance and sharing management with well established and experienced companies. Venture capital is vital in fortifying innovative activity and entrepreneurial talent as it serves as an important tool for overcoming some of the inherent barriers to growth caused by prevailing industrial and institutional structure.

## **1.2 Statement of the Research Problem**

Arguably, SMEs have an important role in the development of an economy, as they contribute to the economic development of developing and developed countries.<sup>1</sup> SMEs also contribute in the creation of employment and breeding ground for entrepreneurs, as well as a centre to investment generation and technological development. SMEs are also the sources of domestic and international trade. However, Zanzibar SMEs do not perform well and their contribution to the economy is limited as a result of different factors.

Basically, there are three key factors which explain for the underdevelopment of Zanzibar SMEs, BOT Report (2006). These factors include a weak business environment, a lack of managerial or technical capacity and a lack of access to capital. In this study, the interest is to focus on one factor only which is the access to capital for growth-oriented SMEs.

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Having in mind such factors affecting development of SMEs, it is unequivocal that SMEs need reliable financial sources that will enable them to obtain necessary capital for their development and VC is one of the alternative sources for SMEs to raise their capital in order to grow.

Zanzibar SMEs are facing a serious problem of lack of affordable financial sources necessary for raising capital. The main source of finance for these SMEs is loan through banks. But such loans are highly restricted with a number of conditions and are subjected to high rate of interest which is unaffordable to the SMEs, BOT (2006) alternatively; a Venture Capital could have been deployed by Zanzibar SMEs as alternative source in raising their capital as it does not involve much restrictive conditions than loans from commercial banks. Arguably, to-date there is no well-defined venture capital in place in Zanzibar for the support of SMEs.

This research therefore tries to analyze whether the deployment of venture capital as a financial source to Zanzibar SMEs would affect their business growth. Research focuses on analyzing a mechanism of funding SMEs through venture capital in Zanzibar and explain, the impact of formalized venture capital vis-à-vis other financial means in supporting SMEs.

### **1.3 Research Objectives**

#### **1.3.1 General Research Objective**

To analyse to what extent the venture capital could be deployed as a source of financing SMEs in Zanzibar.

### **1.3.2 Specific Research Objectives**

This study has the following specific objectives:-

1. To examine the awareness of the Zanzibar SMEs towards venture capital as a significant source of financing.
2. To investigate how potential the venture capital could be in financing SMEs in Zanzibar.
3. To analyse the compatibility of venture capital to Zanzibar SMEs environment and suggest the feasible mechanism of moving to venture capital within the islands.

### **1.4. Research Questions**

#### **1.4.1 General Research Question**

The research will basically gear to address the question as to whether the venture capital could have an impact on Zanzibar SMEs. This question intends to explore the experience of Zanzibar SMEs by having or having not in place, a formalised venture capital.

#### **1.4.2 Specific Research Questions**

Apart from the general research question as described above, in this study, the research will be trying to respond to two specific questions. Such questions are as follows:-

1. Are the Zanzibar SMEs aware of venture Capital as a significant source of financing?
2. What is the potential of venture capital in Zanzibar SMEs development?
3. What is the feasible mechanism of moving to venture capital?

### **1.5 Relevance of the Research**

This study is fairly relevant in terms of its significance to the Zanzibar business community and the entire public. SMEs in developing economies have been suffocating due to lack of financing. With raised awareness of its significance to the public and proper mechanism of

its management, both the SMEs and the fund managers could be in a win win situation. This could later translate to conducive SME development, raise SME contribution to the GDP and reduce poverty.

### **1.6 Organization of the Research**

In this study, there are five chapters. The introductory part forms Chapter One of the study, Chapter Two bases on the literature review trying to explore several studies relevant to this research and necessary gaps in those studies which need to be addressed in this study. This chapter has defined some of the key phrases used in this study. Chapter Three research methodology of the research which include data collection, processing and analysis

Chapter Four discusses the findings; in general the findings are explaining different issues that examine whether the Zanzibar SMEs have access to the venture capital as source of financing to their enterprises. And Chapter Five explains the recommendations based on analysis and results.

## **CHAPTER TWO**

### **2.0 LITERATURE REVIEW**

#### **2.1 Overview**

This chapter presents the review of some issues related to the impact of access to finance for Zanzibar SMEs specifically on Venture Capital Finance. The first section of this chapter presents the conceptual definitions of SMEs and Access to Finance Mode. That is followed by presentation of the empirical analysis of the relevant studies from the developing countries and developed countries which represent some facts about Venture Capital Finance.

#### **2.2 Conceptual Definitions**

It is ideal to define in the first place, the meaning of some terms used in this study avoid potential confusion and misunderstanding. For example, very often, the unstated, but powerful assumption is made that SMEs are a kin to micro/survivalist enterprises. This is erroneous and misleading, particularly regarding the financial products related to debt, equity, and financial services. This study provides therefore, the meaning of small and medium enterprises below:-

##### **2.2.1 Small and Medium Size Enterprise**

The SMEs is used to mean micro, small and medium enterprises. It is sometimes referred to as micro, small and medium enterprises (MSMEs). The SMEs cover non-farm economic activities mainly manufacturing, mining, commerce and services. There is no universally accepted definition of SME. Different countries use various measures of size qualifying for SME depending on their level of development. The commonly used yardsticks are total number of employees, total investment and sales turnover

In the context of Tanzania, micro enterprises are those engaging up to 4 people, in most cases family members or employing capital amounting up to Tshs.5.0 million. The majority of micro enterprises fall under the informal sector. Small enterprises are mostly formalized undertakings engaging between 5 and 49 employees or with capital investment from Tshs.5 million to Tshs.200 million. Medium enterprises employ between 50 and 99 people or use capital investment from Tshs.200 million to Tshs.800 million.

### **2.2.2 Access to Finance Mode**

There are various financial modes or systems that used which are Bank based system and market based system, although there are fundamental differences between bank credit, on one hand and venture capital or equity on the other hand. In a broader sense, one can distinguish between bank-based systems and Market-based systems.

### **2.2.3 The Bank-Based System**

Businesses in countries with large banking sectors have often developed close relationships with banks as the latter have taken on a central role in providing finance and securing industrial development. In mature industries with incremental technological change and low uncertainty and in which learning is linked to a gradual accumulation of tacit knowledge, bank-based systems appear relatively effective in supporting long-term investment through loans.

This type of system is characterised by concentrated ownership, whereby banks have large stakes in industrial corporations, and can further increase monopolistic tendencies. High collateral in the form of tangible assets or secured future cash flows, are generally required as a precondition for granting loans. Intangible assets (such as brand names, patents, R&D, software, etc.), with high growth opportunities, may be poorly rewarded. Due to incurred



sunk costs, banks are often reluctant to write off loans and sell equity even when they are aware that its value has dropped. This typically makes the system relatively less effective writing off the value of declining companies and affects the reallocation of resources and economic dynamics in a negative way.

#### **2.2.4 The Market-Based System**

In market-based systems, venture capital investors and financial markets are more suitable in supporting innovative and high-risk companies. Liquid stock markets are also main features of countries with market-based systems. There is greater transparency and more active markets for corporate control, giving investors stronger incentives to exercise high-quality assessment and monitoring. The importance of intangible assets, which are now crucial in many knowledge intensive areas, is more readily appreciated, and greater efforts are made to measure and convey their value.

This creates superior growth opportunities in many areas marked by high risk. However, in order to obtain financing, companies must disclose information effectively. Fund can be reallocated more quickly between companies and industries than in bank-based systems, though there are high fixed costs in connection with the issuing of shares or bonds. In market based systems, common law frameworks based on the English tradition protect shareholders and creditors. Therefore, greater legal protection of minority owners implies less need for ownership concentration, which again increases access to external finance and reduces capital costs for companies.

### **2.2.5 Own Financial Sources**

Source of finance can be internal or external; the following is a brief description of them.

### **2.2.6 Borrowed Internal Financial Sources**

Borrowed internal sources mean commitments of entrepreneur to employees in a form of unpaid wages, salaries, and bonuses, to partners from their deposits and further sources that contribute to financing of enterprise activities. Commitments to employees arise when enterprise does not have enough financial sources to pay them. Labour force produces outputs that bring revenues to enterprise.

### **2.2.7 Borrowed External Financial Sources**

Entrepreneur uses borrowed external financial sources because of lack of private capital and because of taxation point of view; interests are part of costs and thus they decrease tax base. External financing sources accessible for SMEs have expanded substantially over the past 5 years. The main engine of growth, however, was the introduction of the new cheaper credit assessment and debtor-rating procedures worked out by the commercial banks, the current development dynamism suggests that, in terms of financial intermediation to SMEs, the gap between more developed market economies and developing economies will become smaller in the coming years. Bank financing of micro, SMEs proved dynamic development by Frank and Mayer (1998)

### **2.2.8 Bank Loan**

Bank loan is a contract between creditor offering the financial sources and debtor. Bank offers a loan to cover present needs and thus allows the enterprise to provide fluency of reproduction process.

### **2.2.9 Venture Capital**

Venture capital involves the provision of investment finance to SMEs in the form of equity or quasi-equity instruments not traded on Recognize Stock exchanges. It is long-term risk finance where the primary return to the investor derived from capital gains rather than dividend income. Venture capital investors are actively involved in the management of the investee company, with the intention of helping to assure success of the venture, Bebchuck (1999)

A distinction is usually made between venture capital and seed capital. Seed capital refers to direct equity capital in start-ups in the initial rounds of finance. Venture capital, on the other hand, refers to the next round of finance in companies that have achieved stability and have growth potential by Frank and Mayer (1998)

A venture capital fund would typically invest in an SME in a high-growth sector looking to expand its operations. Venture capital can also play a role in buy-outs of more established companies. The involvement of a venture capitalist is usually from two to four years, after which the venture capitalist will typically either sell the shares of the company on a stock exchange, e.g. an initial public offering (IPO) or sell the whole stake in the company, e.g. to a more established competitor.

Venture capital has the potential of offering valuable entrepreneurial talent and serves as an important tool for overcoming some of the inherent barriers to growth caused by prevailing industrial and institutional structures. Roles of Venture capitalists provide financing to new often high risk ventures by Pool funds from various sources and invest them actively in running the firm by providing support to the firms with their prior experiences and general expertise by Frank and Mayer (1998).

Venture capital differs from traditional financing sources in that venture capital typically:

- i) Focuses on young, high-growth companies;
- ii) Invests equity capital, rather than debt;
- iii) Takes higher risks in exchange for potential higher returns;
- iv) Has a longer investment horizon than traditional financing;
- v) Actively monitors portfolio companies via board participation, strategic marketing, governance, and capital structure.

Successful long-term growth for most businesses is dependent upon the availability of equity capital. Lenders generally require some equity cushion or security (collateral) before they will lend to a small business. A lack of equity limits the debt financing available to businesses. Additionally, debt financing requires the ability to service the debt through current interest payments. These funds are then not available to grow the business.

Venture capital provides businesses a financial cushion. However, equity providers have the last call against the company's assets. In view of this lower priority and the usual lack of a current pay requirement, equity providers require a higher rate of return/return on investment (ROI) than lenders receive (Bebchuck (1999))

#### **2.2.10 The Venture Capital Process**

A startup/high growth technology companies looking for venture capital can expect the following process.

#### **2.2.11 Submit Business Plan**

The venture fund reviews an entrepreneur's business plan, and talks to the business if it meets the fund's investment criteria. Most funds concentrate on an industry, geographic area, and/or stage of development (e.g., Start-up/Seed, Early, Expansion, and Later).

### 2.2.12 Due Diligence

If the venture fund is interested in the prospective investment, it performs due diligence on the small business, including looking in great detail at the company's management team, market, products and services, operating history, corporate governance documents, and financial statements. This step can include developing a term sheet describing the terms and conditions under which the fund would make an investment.

Venture capitalists evaluate the potential and quantify the success of an investment using Two metrics: -

- a. Internal Rate of Return (IRR) – The IRR of an investment, which is the discount rate that makes the net present value (NPV) of the investment cash flow stream equal to zero. A project may be a good investment if its IRR is greater than the rate of return that could be earned by alternate investments of equal risk (i.e. higher than the VC hurdle rate).
- b. Cash-on-Cash ("CoC") – CoC is simply equal to how much the VC receives in proceeds upon exiting the investment divided by how much it initially invests in the company and, unlike IRR, is not dependent on when the exit actually occurs.

Rather than compute single IRR and CoC figures for a given investment opportunity, VCs compute a range of such figures that consider varying degrees of operating success and different exit multiples. Before the VC can compute IRR and CoC, it must first determine its ownership stake in the company post-investment. This simple computation is performed in a capitalization table ("cap table"), and divides the common share equivalents purchased by the VC by the total common share equivalents outstanding after the investment is made. The resulting percentage is then multiplied by the exit-year valuation to determine what portion of the exit proceeds is attributable to the VC

### **2.2.13 Investment**

If at the completion of due diligence the venture fund remains interested, an investment is made in the company in exchange for some of its equity and/or debt. The terms of an investment are usually based on company performance, which help provide benefits to the small business while minimizing risks for the venture fund.

### **2.2.14 Execution with VC Support**

Once a venture fund has invested, it becomes actively involved in the company. Venture funds normally do not make their entire investment in a company at once, but in “rounds.” As the company meets previously-agreed milestones, further rounds of financing are made available, with adjustments in price as the company executes its plan.

### **2.2.15 Exit**

While venture funds have longer investment horizons than traditional financing sources, they clearly expect to “exit” the company (on average, four to six years after an initial investment), which is generally how they make money. Exits are normally performed via mergers, acquisitions, and IPOs (Initial Public Offerings). In many cases, venture funds will help the company exit through their business networks and experience.

## **2.3 Empirical Analysis of Relevant Studies**

Some studies have been done which are in a way related to this study, hereunder are some of the relevant studies:-

### **2.3.1 Experience from the America, Asia and European Countries**

In their study, Patricof (2005), Sunderland (2005) argue that in developed country environments, young companies are financed by various types of risk capital providers through a number of rounds of investment, friends and family supplying very early capital,

angel investors such as retired businessmen providing start-up capital and formal venture capitalists providing early-stage and growth capital.

Each of these types of investors has specialized skills and information to evaluate the risks and rewards of the business plan at each stage of investment and to help the entrepreneur build the business.

They further argue that almost all developing countries lack this early risk capital market. These authors propound that surveys of the SME sector in developing countries have consistently identified lack of access to capital as a key constraint to growth. Apple Computer, Microsoft and Fedex did not start out with loans and that if their founders had been required to finance their early growth with the short-term, collateralized, high interest loans currently available in developing countries, and their businesses would not even have gotten off the ground. Instead, friends and family, angel investors, venture capitalists and even the USA Government's Small Business Administration provided risk capital to build these successful USA companies. The stated scenario suggests that developing countries, must similarly find a way to get equity capital into the hands of entrepreneurs who have the capacity to build young businesses.

This study relates with the intended research on analysing the impact of venture capital to SMEs, such study tried to analyse general picture within developing countries without specificity of looking at SMEs of certain area. Though Zanzibar belongs to the developing countries, yet there is a dire need to have specific study for the impact of the venture capital for Zanzibar SMEs.

In its position paper, European Association of Craft (2004), SMEs has stated that there has been substantial increase in cost for banks in providing its services to its clients including the provision of loans to SMEs. This is due to competition on interest rates and higher fees for its services (administration of accounts, payments systems, etc.), which become burden to SMEs but more importantly, limit their liquidity, future of SME Finance (2004). The position paper reiterates the fact that such scenario will make access to finance for SMEs even more difficult and therefore will hamper the development of SMEs especially those who are engaged in start-ups business. This position paper which tries to investigate the access to finance to SMEs in Europe, further establishes the preposition that even the European SMEs have been experiencing difficulties in financing their investment as a result of shortage of finance especially from banks. The paper has relevance with the intended research as it reflects the difficulties the SMEs have been experiencing in financing their trades especially when relying to banks as a source of finance for those trades. Although the paper basically reflects the European experience, still it compliments to this study and it suggest other mechanisms of developing growth of SMEs. However, the position paper has not exhaustively explored the alternative mechanisms to finance SMEs. This research therefore will traverse beyond by analysing the venture capital as alternative means of financing SMEs in Zanzibar.

Grimsholm (2010) and Poblete (2010) in their study of the Internal and External factors hampering SME growth shows the significance of SMEs within an economy emphasize the importance of having governmental policies that support SMEs, Issuing regulations that help them and their ability to operate efficiently and regulations that imply low administrative costs, although there has been an increase in governmental policies promoting and supporting SMEs in order to achieve economic growth and reduce poverty,



there is still a lack of laws, administrative procedures and access to assistance from governmental agencies.

They also explain that insufficient capital or lack of financial sources is the major obstacle for SMEs and usually entrepreneurs need to utilize personal financial sources to start up their business and to expand the operations, since the internal financial sources are normally insufficient. There are policy biases towards large enterprises and small firms face problems in growing due to lack of access to finance.

The authors provide that SMEs have difficulty in growing due to insufficient collateral, high transaction costs and incapability to deal with the complexity of formal financial institutions. Moreover, SMEs in developing countries generally do not get accepted formal bank loans because of perceived high risk of default, low profitability and incapability to demonstrate required physical collateral.

Zanzibar also can adopt this way by having government policies that support SMEs in terms of excess to finance policy that guide SMEs for Issuing regulations that help them and their ability to operate efficiently and regulations that imply low administrative cost.

Zeisberger (2010) discussed and analyzed the current issues and also project the future role of government in venture capital development in Hong Kong. The author states that there must be a change of attitude and various reforms to be made to government's policy toward technology and innovation. This argued that coupled with the business opportunities created by mainland China's rapid economic development, caused the subsequent growth in Hong Kong's venture capital sector. Today, Hong Kong has developed into the largest

venture capital centre in Asia, managing almost one-third of the total capital pool in the region. Government plays a vital role in maximizing venture capital's impact on a society.

This literature demonstrates the significance of venture capital in the development and growth of economies and for that matter, entrepreneurs. The reforms suggested in the literature, could be applicable in case of Zanzibar in that there is also a need for Zanzibar to embrace various reforms towards development of entrepreneurs.

The literature compliments the intended research work as it relates with the subject matter of the role and significance of venture capital. However, the role of venture capital in the development of attracting capital in China (as propounded by Claudia 2010) is not associated with the development of entrepreneurs.

Prelicean and Boscoianu (2010) argued that there is a need for enhancement of venture capital in developing countries for stimulating entrepreneurship by making use of venture funds and responding to the demand for strong expertise needed.

The authors strongly established that in developing countries, there is a need to have in place, a public policy to support institutional systems for stimulating venture funds which may support new establishment. Accordingly, they are of the opinion that entrepreneurs have innovative ideas but are constrained with capital to financing their trade and therefore VC has evolved as a response to this critical need for capital.

What is asserted by the authors' very relevant to this work as the emphasis in the literature is on the need to have public policy to support venture capital for the purpose of enhancing

entrepreneurship development. The authors however, seem to focus on public venture capitals believing that is a solution for capital constraints facing the entrepreneurs from developing countries. This work does not intend to confine itself into analysing public venture capital but rather will look on the concept of venture capital on its generality.

### **2.3.2 Experience from Sub - Saharan Africa**

The Task Group of the Policy Board for Financial Services in their study dedicated for examining access to finance for South African SMEs, argue that start-ups, micro-enterprises, entrepreneurs from previously disadvantaged communities or any other group with limited collateral or weak (or limited) credit histories access is more limited. It is argued in that study that depending upon their stage of growth, the most appropriate form of finance for SME development is frequently venture capital rather than debt.

In justifying their preposition on the significance of venture capital as appropriate form of finance, the group propound that start-up entrepreneurs are often commercially inexperienced and hence in giving managerial advice, venture capitalists can enhance the success of innovative but highly risky ventures.

The group provides that the performance of South African venture capital funds is healthy and in line with international rates of return. It is further argued in that study that although there is no known value or estimate of the management advice provided by venture capitalists to their invested companies, it is probable that the 'skill improvement' effect of venture capital was a significant additional benefit.

The Tanzania Small and Medium Enterprise Development Policy have tried to analyse the environment of SMEs in Tanzania and factors which affect growth of such SMEs.

It is stated within the policy that SME sector in Tanzania has limited access to finance due to the following factors: the sector is perceived as a high risk one; inability of the SME operators to fulfil the collateral requirements, most banks do not operate an SMEs financing window, some of the banks operate in limited geographical areas; inexperience of bank staff in issues related to Micro-finance, lack of a guarantee scheme to back up banks financing SMEs, high cost of screening and administering small loans spread over big areas and inabilities of borrowers to prepare and present applications that meet bank's requirements.

The policy further provides that currently there has been reforms aiming at strengthening SMEs in Tanzania and such reforms have resulted in liberalisation of the financial sector to a great extent. This has led to establishment of a number of banks including the Micro Finance Bank, liberalisation of financial rates and establishment of a stock exchange market.

In spite of all these reforms, the policy provides that SMEs sector is facing a major constraint in accessing finance. This limits their capacity to survive, increase capacity, upgrade its technologies and even in many cases, expand their markets and improve management or raise productivity and eventually increase incomes.

SME Development Policy had analysed the SMEs, their development, their potential sources of finance and constraints towards accessing funds, for Tanzania Mainland. Though there might be similar operational circumstances between Zanzibar SMEs and their counterparts in Tanzania Mainland, yet there is a need to undertake a study, specific for Zanzibar.

Further, although the policy examined the issue of access to finance for the SMEs, it did not undergo a thorough analysis of venture capital as a potential source of financing SMEs. This research therefore, will go beyond the scope of the policy by looking into the venture capital and their impact to Zanzibar SMEs. (DaibiDagogo) and Walter Ollor (2005) argue that finance is by no means the only important constraint to SME development. Other constraints include inadequate entrepreneurship and managerial skills, financial indiscipline, enabling environment for investment, and weak monitoring mechanism to address all these, Nigeria came up with new strategy known as the Small and Medium Enterprises Equity Investment Scheme (SMEEIS). The scheme involved the use of venture capital (VC) financing.

The authors argue that if Nigerian SMEs work closely with venture capitalists, they could transform to large enterprises within an acceptable period of time given the essential ingredients of VC financing as they consider venture capital to be more strategic than debt finance as the latter had disappointing outcomes to many Nigerians SMEs.

They further argue that their study shows that the economic value added of VC-financed SMEs presents the most divergent performance in the debt-equity preference analysis as they grow at an increasing rate while that for non VC-backed SMEs grows minimally. That study suggests that the key driver of such distinctive performance is the management support offered by venture capitalists to their portfolio SMEs.

Onugu, J (2005) in his work investigated the performance of the Small and Medium Enterprises sub-sector of the Nigerian economy, its problems and prospects and recommended measures to be taken in making the sub-sector vibrant in order to play the crucial role it is expected to.

He further stated that SMEs have played and continue to play significant roles in the growth, development and industrialization of many economies the world over. In the case of Nigeria, SMEs have performed below expectation due to a combination of problems which ranges from attitude and habits of SMEs themselves through environmental related factors, instability of governments and frequent government policy changes. Among the reasons for Nigerian SMEs to perform below expectation, the author considers the poor access to finance as the major reasons.

In that respect, the author's investigation confirms the significance of access to finance towards the growth of SMEs and the consequence of poor accessibility of finance. The author however, has generalised the point of financial accessibility without confining to the venture capital. Therefore this work will compliment that literature by analysing different modes of financial accessibility to the SMEs including venture capital.

It is stated that Small- and Medium-sized Enterprises are essential to a well-functioning economy. According to Norfund this type of enterprise gives rise to local employment, diversification and economic growth. Investment in this type of fund is a convenient strategy for reaching out to small- and medium-sized enterprises, because investment in the SME sector is challenging, and the enterprises require close follow-up. Experience shows that selected local funds managers can do this job in an appropriate manner, and contribute to creation of considerable value. Norfund Company has accumulated competence in selection of fund managers and establishment of appropriate fund structures in Africa.

According to this literature Norfund invests equity capital in private equity funds, such as venture capital and other investment funds targeting SMEs that require growth capital and

expertise as many SME's do not have access to commercial capital because of their small size in Angola where it has injected 50% of the capital of FIPA company and build such institution in terms of expertise for years by investing in SMEs funds and fund managers, Norfund helps build the formal economy and strengthen local capital markets.

This signifies that there have been efforts to strengthen support to SMEs through venture capital as alternative to loans and other mechanism of supporting those entrepreneurs. However, despite this progress in developing venture capital in East African region, there is no proof as whether such significant development in venture capital investment transcended to Zanzibar and therefore this study will try to examine in an in-depth how venture capital has impacted development of SMEs in Zanzibar.

AWAF is a fund investing in SMEs in West Africa (2003) it has a particular focus on Nigeria, Ghana and Senegal. The fund has a total capital of NOK 290 million, whereof Norfund has invested NOK 76 million. Other investors include Britain's CDC, the European Investment Bank (EIB) and two local commercial banks in Nigeria.

### **2.3.3 Experience from East Africa**

It is argued that there is a new breed of entrepreneur now emerging in East African countries, which are looking to develop markets but they require assistance in terms of technology, markets and funding. According to the article there are difficulty and complexity in doing business in Africa especially in identifying and developing the available opportunities. It is clear that the entrepreneurs need VC Company to develop the business, especially in assisting in providing trainings and management assistance, as well as technical support.

Based on the above fact, the article has tried to underscore new sources of investment available, ranging from specific development funds designed for SMEs, SME loans from mainstream banks and Venture Capital.

One of the experiences of development of VC in East Africa is AEAF investment in small- and medium-sized enterprises in the region in 2003 which primarily aimed to support SMEs in Kenya, Tanzania and Uganda. That large investment of a total capital equal to NOK 230 million, focused in the development of its investments but more importantly, to provide management skills, strategy and business development, as well as targeting in improvement of financial management and reporting in the enterprises. Primarily it targeted to have in place sound and viable enterprises for the purpose of enhancing economic growth.

Fanisi Venture Fund East Africa (2009) is one of the venture capital fund supporting East Africa SME'S by injecting \$ 50 million for investing of potential business in East Africa according to the source the support has focused on agribusiness, health care, light manufacturing , financial services, oil, and gas that provides risk capital, Despite this large capital investment by Fanisi venture capital fund in East Africa, this source does not provide any explanation with regard to the extent this investment had extended and impacted Zanzibar SMEs. As such it is still relevant for this study to analyse the impact of venture Capital to Zanzibar SMEs.

Fanisi Venture Management is a management company that manages Fanisi Venture Fund East Africa. Norfund owns 50 per cent of the company, the remaining half is held by Amani, which is owned by the employees. Norfund initiated the establishment of the



company, based on a wish to develop the capital market in East Africa by setting up management capability in an area that was underdeveloped in the East African market established venture capital firms avoid investing with inexperienced investors in the early investment stages, especially in the seed investment round, because this would involve admitting those investors into the early decision making stages where most crucial decisions are made.

By imposing high interest rates, high collateral requirements, and restriction of collateral to specific assets. Commercial banks often discriminate against SMEs because they are considered “high risk” clients with little or no resources to provide collateral. For instance, real interest rates on loans can go beyond 25 per cent, and all commercial banks operate with the same loan conditions. Business owners complain about the inflexibility of banks in enforcing onerous collateral requirements for any credit they extend.

SMEs access to working capital in the form of short-term loans and overdraft facilities is highly limited in Tanzania. Banks and other financial institutions have no confidence in SMEs as they are perceived as high-risk ventures with high rate of failure. They establish prohibitive collateral conditions that most SMEs cannot afford.

In Tanzania, the Zanzibar National Chamber of Commerce Industry and Agriculture (ZNCCIA) as a Private Sector Organisation provide affordable access to localized, formalized and customized business management training on capacity building by providing proper interactive tools through grants to facilitate the growth of their business.

The apex of the private sector In Tanzania (TPSF) with development partners who fund the project of Business Development Gateway (BDG) improve access to financial services for small and medium-sized companies also the Financial Sector Deepening Trust it enhances

value addition through innovation and competitiveness for SMEs to become better manufacturers, suppliers, and distributors in Tanzania for the creation of better business environment.

## **CHAPTER THREE**

### **3.0 GENERAL RESEARCH METHODOLOGY**

#### **3.1 Overview**

This chapter explains the methodology adopted in this study. It describes the groups of people involved in the study and the location from where the study was conducted. In the course of going through different literatures, the researcher discovered a number of methodologies which have been applied in conducting the studies as referred in this study. In some of the studies reviewed, their respective authors have used only one methodology while others have used more than one methodology. Some of the work primarily focused on questionnaire to obtain findings. Such works which adopted this methodology include that of Onungu (2000), where the researcher used Questionnaire as form of collecting data. But there are also some works which used multiple methodologies to conduct the studies. For instance interview, questionnaires, desk work methodologies have been used in conducting one study. Among the works which used varieties of methodologies include Dagogo and Ollor (2005),

The study used a cross sectional design, which this was selected because of the nature and its advantage, these design is a cheap to undertake and useful to get information on a particular study time. Moreover, the study was able to assess the degree of relationship between SMEs growth and the factors hindering it. It also provides useful data for simple statistical descriptions and interpretations.

### **3.3 Area of the Research**

The study was conducted at Urban West Region Zanzibar. The selected area has been considered relevant as a large number of SMEs are located in this region comparing with other Regions in Zanzibar. About 50 % of the SMEs are located in Urban West Region. On the other hand, urban west region is easily accessible and that enhanced availability of sufficient information on the subject matter.

### **3.4 Sample Size**

The researcher obtained information relating to this study through interviews and questionnaire. In total, the researcher intended to interview about ninety three (93) SMEs and expert who are chosen from the related groups because they are conversant with the research related issues. Among such organisations, the researcher interviewed some officials of Zanzibar National Chamber of Commerce, Industry and Agriculture (ZNCCIA), Zanzibar Association of Tourism Investors (ZATI), Zanzibar Institute of Financial Administration (ZIFA), Zanzibar University (ZU), the Planning Commission and similar organisations. These few institutions were chosen because of their expertise in the profession as compared to other organisations. Also the researcher had chosen relatively small number of SMEs due to several reasons. That includes the difficult availability of SMEs who were engaged with their businesses, random location of business places where these SMEs locate. Also among the challenges faced is non existence of some of the SMEs who were in the register of businesses but were no longer operating business. Despite of these challenges, the researcher considered the size of the sample to be reasonable and able to represent the SMEs in Zanzibar.

The Interview questions that were asked to the experts were made up of number of questions which were intended to be asked to 93 SMEs across the Zanzibar Urban West

region, of which only 87 were interviewed and 6 SMEs did not appear for interview as planned.

### **3.5 Sampling Methods**

A simple non random sampling was employed in the selection of the sample for the study. Based on non probability sampling, respondents are selected on the basis of their availability in the population. Thus, the researcher has used respondents that were available from the group of SMEs as opposed to picking respondents from the entire population within the respective region. This helps in obtaining relevant respondents who can provide relevant information.

### **3.6 Methods of Data Collection**

During this research, the researcher collected primary data. The primary data were obtained from SMEs, experts, academicians and business persons. Structured questions were used to get the information. Interview questions were refined and improved to take care of the observed shortcomings and make the questions easier to respond. Interview method became significant in this research especially in obtaining views of some experts with regard to their accessibility to venture capital and other forms of support to SME's. Quantitative and qualitative approaches were also used in this research for a better understanding and possibly enabling a better and more insightful interpretation of the results.

### **3.7 In-depth Interview**

The interviews were conducted by the researcher to managers and lower level officials. A semi-structured approach was used to enable the interviewees to speak relatively freely and at the same time allowing the researcher to ensure that most of important issues are covered.

### **3.8 Data Processing and Analysis**

The data collected were processed using SPSS. Several analytical methods were used in line with the specific objectives of the study. A descriptive analysis was deployed by the researcher in order to summarise the available data. This includes percentages and frequencies, the quantitative data were measured in real values, table and other graphical presentations which were used to reflect the collected data to facilitate easy understanding but also convenient analysis.

## **CHAPTER FOUR**

### **4.0 FINDINGS AND ANALYSIS**

#### **4.1 Introduction**

Chapter four discusses major findings from analysis of the data collected including from responses to the research questions. In general the findings are explaining different issues that examine the potential of venture capital as a source of financing their enterprises. The study also investigated other sources of financing SMEs in Zanzibar especially loans.

#### **4.2 Findings and Analysis**

##### **4.2.1 Introduction**

As stated, the main objective of the study was to analyse to what extent the venture capital as a potential source of financing business, particularly SMEs. As such, the study tried to examine how the accessibility of the venture capital to SMEs in Zanzibar brings impact to the growth of their business.

##### **4.2.2 Presentation of the Results**

Since this study focused on the impact of venture capital to the development of Zanzibar SMEs, Interview was conducted to different groups of SMEs and questionnaires were asked to both institutions and members of the business community who own small businesses.

##### **4.2.3 Response Rate**

The researcher interviewed eighty seven (87) SME's and members from the business community organisation who were chosen from the related groups because they were conversant with the research related issues as stated in the below table:-

**Table 4.1 Response Rate**

<b>Details:</b>	<b>Number</b>	<b>Percentage (%)</b>
Responded	87	93.5 %
Not Responded	6	6.5 %
<b>Total</b>	<b>93</b>	<b>100 %</b>

The study sought to gather information from managers or any individual working on selected SMEs in Zanzibar urban west region. The research was designed to gather information from ninety three (93) firms. However, out of the total of (93) firms selected, (87) firms responded which constitutes 93.5% of the total intended respondents, while non-respondents were six (6) firms which is equivalent to 6.5%.

#### **4.2.4 Age of the Respondents**

The study considered the age of the respondents. The findings are shown in figure below:-

**Table 4.2 Age of the Respondents**

	<b>Number</b>	<b>Range</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std Deviation</b>
Age	87	45	22	67	39.67	10.719

The findings indicate that age range of the respondents was the age of minimum of 22 Years, and maximum age of 67 years, and average age of the respondents was 40 years

#### **4.2.5 Gender of the Respondents**

The study sought to find out the gender of the respondents. The findings are shown in Figure below:-



**Table 4.3 Gender of the Respondents**

Male	Number	38
	Percent	43.7%
Female	Number	49
	Percent	56.3%
<b>Total</b>	Number	87
	Percent	100.0%

The findings indicate that 43.7% of the respondents were male while 56.3% of the respondents were female. This indicates an almost equal distribution of female and male respondents in the study.

#### **4.2.6 Total Number of Employees in Selected SME's Firms**

The study sought to find out the total number of employees in the respondents firms

The findings are shown in Figure below:-

**Table 4.4 Total Number of Employees in Selected SME's Firms**

<b>Descriptions:</b>	<b>N</b>	<b>Range</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
No. employees when the company established	87	99	1	100	12.63	15.497
No. of employees at the current	87	297	3	300	20.37	38.301

The findings indicate that the number of employees when the company established varied which shows minimum number of employee is 1 and maximum is 100 employees. While at the current situation, most of the SME' firms have minimum of 3 employees and maximum of 300 employees.

#### **4.2.7 Level of Education of the Respondents**

The study sought to find out the level of formal education of the respondents in SME's firms and business community organisations. The findings are shown below:-

**Table 4.5 Level of Education**

	Frequency	Percent
No	5	5.7
Secondary	16	18.4
Primary	37	42.5
Certificate and Diploma	11	12.6
Degree and Above	18	20.7
Total	87	100.0

The level of formal education varies in Tanzania from primary, secondary, Certificates, diploma and degrees, the finding indicate that the SME's of urban west region among the respondent 5% of SME's do not perform any level of formal education, 42.5% of the respondent were those who perform primary education, 18.4% of the respondent were those who perform secondary education, 12.6% of the respondent are SME's who undergo for the level of Certificates and diploma and 20.7% of the respondent were the SME's who perform the level of higher learning degrees in formal education

#### 4.2.8 Entrepreneurship Training

The study sought to find out to what extent the following entrepreneurial skills influence the growths of businesses, the results are shown in below table:-

**Table 4.6 Entrepreneurship Training**

Responses			Total
<b>Entrepreneurship training</b>	Yes	Number	49
		Percent	56.3%
	No	Number	38
		Percent	43.7%

The findings indicate that most of the SME's has got influence on entrepreneurship skills, this explained that above the number of the respondent perform well in rate of 56.3% of entrepreneurship have got entrepreneurship knowledge to run the business while only 43.7% of the respondent who do not get training on entrepreneurship business which is less than those who have skills on Business entrepreneurship.

#### 4.2.9 The core product in entrepreneurship Business

**Table 4.7**The core product in entrepreneurship Business

Description	Frequency	Percent
Services	6	6.9
Food Processing	23	26.4
Tourism Sector	36	41.4
Agricultural Product	22	25.3
Total	87	100.0

The findings indicate that about 41.4% of the respondents in urban west region involved in tourism sector, 26.4% of the respondents indicate that, while 25.3% of the respondent involve in agricultural product and only 6.9% in services sector.

#### 4.2.10 Measurement of Growth

The study sought to find out how the company measures growth. The findings are shown in Table below:-

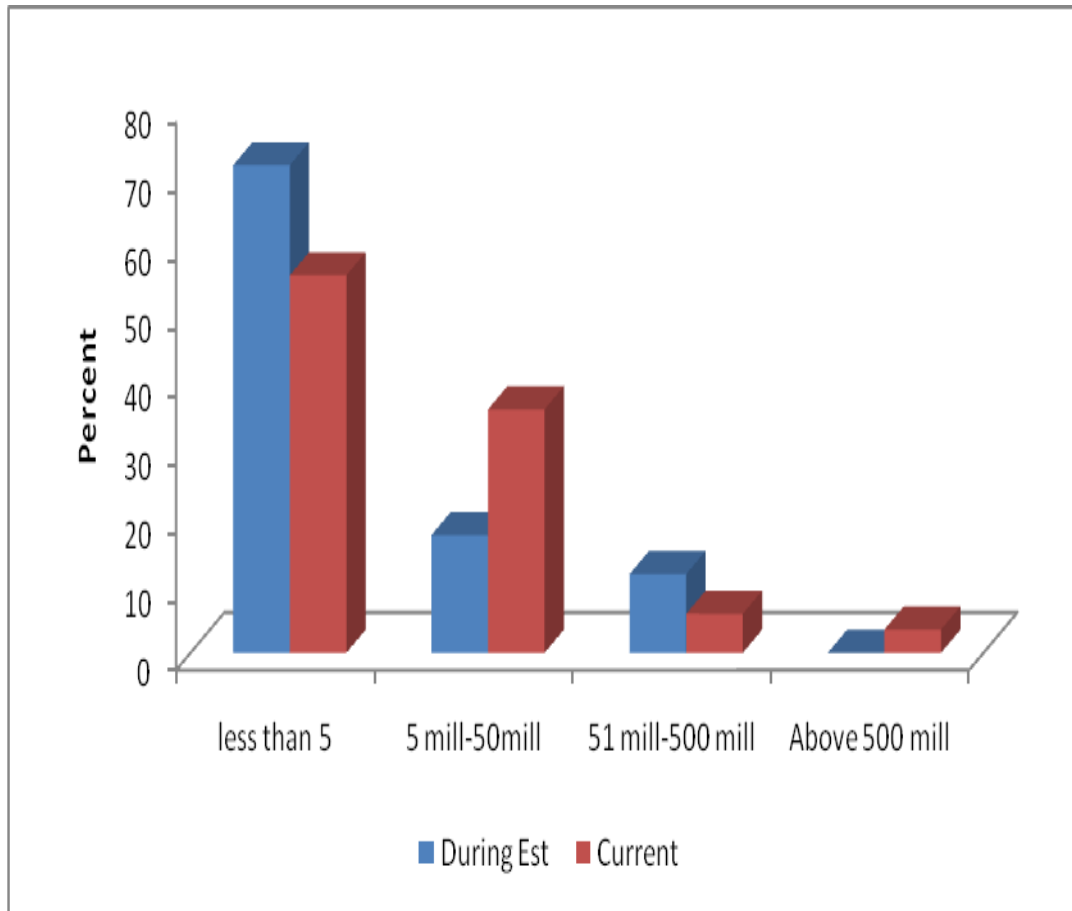
**Table 4.8How the Company Measures Growth**

	<b>Frequency</b>	<b>Percentage</b>
By using income	38	55.1%
By using sales	32	36.7%
By using business partners	17	19.5%
<b>Total</b>	<b>87</b>	<b>100.0</b>

The findings indicate that 43.6% of the respondents indicated that their company measures growth by income, 36.7% by using sales while 19.5% used business partners.

#### **4.2.11 Annual turnover of the SME's Firm Establishment before and current**

The study sought to find out to what extent the annual turnover rate affect the growth of businesses at the time of firm's establishment compared with the current situation. The results are shown in Table below:-



**Figure 4.1 Annual turnover when the firm establishment**

This indicates that there is effect on the growth of SMEs to a very great extent, low level of turnover 0-5mill during start-up of business will effect business opportunities to by falling down of its capital, the finding also indicate that turnover from 5mill-50mill start with law capital but after a number of years of the business operations indicate that the business grow by increase its turnover, and turnover of 40mill-100millalso finding indicate that the business rise its capital and grow well after few years of its operation.

#### 4.2.12 Response from factors hampering growth of SME

The study sought to find out to what extent does these factors hampering the growth of SMEs businesses. The following result were presented in table 4.10 below shows that

**Table 4.10**Response from factors hampering growth of SME

	<b>Great extent</b>	<b>Moderate extent</b>	<b>Not at all</b>	<b>Total</b>
Access to Capital	(73)  83.9%	(11)  12.7%	(3)  3.4%	(87)  100%
Government Policy	(37)  42.6%	(34)  39.1%	(16)  18.3%	(87)  100%
Lack of Information	(27)  31.1%	(29)  33.4	(31)  35.7	(87)  100%
Loan Requirement	(53)  61.0%	(25)  28.8%	(9)  10.2	(87)  100%

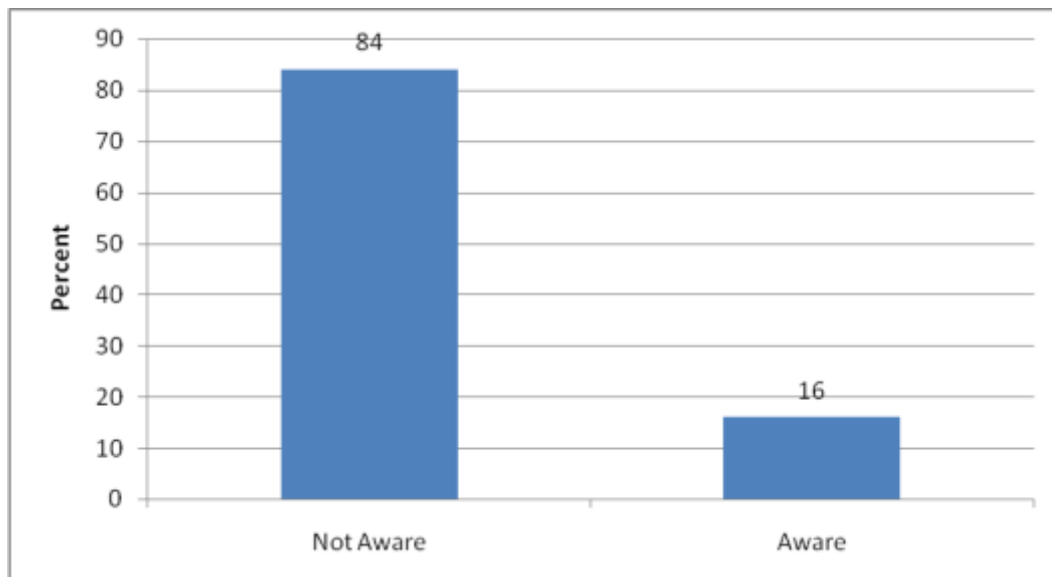
access to capital show that has great extent in the contribution of SME's development for about 83% of the respondents agree on that while loan requirements also prove that is not in favour of SME's to sustain its business as most findings show great extent to the loan requirements for about 61% of respondents, government policy and information has moderate extent in the features that hampering growth of SME's in Zanzibar.

#### 4.2.13 Response from the Specific Objectives of the Study

##### 4.2.13.1 Objective One

To examine the awareness of the Zanzibar SMEs towards venture capital as a significant source of financing SMEs.

The study sought to find out the extent of awareness on venture capital as a significant source of finance to SME's and possible mechanism of moving towards venture capital.



**Figure 4.2 Status for Level of awareness to Zanzibar SMEs**

Out of 87 respondents, 73 respondents which is equivalent to 84% were not aware on Venture capital as a source of finance in their business while only 14 respondents which is equivalent to 16% were aware of venture capital as a source of financing SME's.

From the interview discussion with the officials from Zanzibar National Chamber of Commerce (ZNCCIA) respond that *there is a need for enhancement of venture capital in Zanzibar for simulating entrepreneurship by making use of venture funds*, responding to the demand as shown in BDG Programme. The programme initiates to provide affordable



access to localized, formalized and customized business, management training provided to build the capacity of entrepreneur in providing proper interactive tools through grants to facilitate the growth of their business. Business Development Gateway (BDG) fund is the special fund provided from the development partners for the aim of improves access to financial services for small and medium-sized companies.

Respondent explained that *entrepreneurs have innovative ideas but are constrained with capital to financing their trade and therefore VC has evolved as a response to this critical need for capital to Zanzibar SMEs.*

**Table 4.12 Data for Participants on BDG Programme year 2011/2012 is as shown below:-**

S/N	Region	Selected Applicants		Fund Granted per Region		Total Fund Disbursement
		BDP	BPC	BDP	BPC	
1	Urban Region	68	9	224,400,000	25,200,000	249,600,000
2	North Unguja	20	0	67,100,000	0	67,100,000
3	South Unguja	24	0	70,400,000	0	70,400,000
4	North Pemba	46	3	139,700,000	8,400,000	148,100,000
5	South Pemba	41	5	125,400,000	14,000,000	139,400,000
	<b>Total</b>	<b>199</b>	<b>17</b>	<b>627,000,000</b>	<b>47,600,000</b>	<b>674,600,000</b>

**Source: ZNCCIA Database (2011/2012)**

The above table show the number of participants in BDG programme from different regions of Zanzibar and the fund disbursement for the region based on the grant plan for the year 2011/2012, Urban west region has high demand for access to finance as the number of SME in urban region is high, there about 400 SME's in urban region and the data show that only 77 SME's were those who already secure BDG grants for the improvement of its businesses.

#### **4.2.13.2 Respondents Suggestions**

*In examine the awareness of the Zanzibar SMEs towards venture capital as a significant source of financing SMEs*

#### **4.2.13.3 Education about Venture Capital**

Based on the finding through this study which revealed that most of the SMEs are not aware of Venture Capital, respondents proposed the need to have public forum and business meetings on the concept of Venture Capital and other investments issues; this will create awareness and give the business community knowledge on different issues that will assist them in their business matters.

#### **4.2.13.4 Entrepreneurial Venture Capital Organization in Zanzibar**

This study has revealed that there is significance of having in place an Entrepreneurial Venture Capital Organization in Zanzibar. According to the respondents, the establishment of such an organization will have effects on finding good deals for SMEs in Zanzibar which will have significant impact towards the growth of the SMEs. Arguably, the deals which have been looked by such organization and found to be appropriate will definitely attract more SMEs. This is based on the belief that entrepreneurs in general would only

take calculated risks and therefore would only invest in business ventures that seem profitable to them.

#### **4.2.13.5 Objective Two**

To investigate how potential the venture capital could be in financing SMEs in Zanzibar visavis other sources of finance:

The study sought to find out how potential the venture capital could be in financing SMEs in Zanzibar visavis other sources of finance with specific case of loans requirements from Banks. The results are shown in below Table:-

**Table 4.13 Status of the potential of the venture capital in financing SMEs**

<b>Status of the potential of the venture capital in financing SMEs</b>	<b>Frequency</b>	<b>Percentage</b>
Strongly Agree	56	64.3%
Agree	17	19.5%
Slightly Agree	13	14.9%
Disagree	1	1.1%
<b>Total</b>	<b>87</b>	<b>100</b>

With respect to the SME's in processing and obtaining loans, there are a lot of inherent challenges within it. The challenges faced according to respondents include high interest rates imposed by banks while offering loans; high collateral requirements; and restrictions of collateral to specific assets.

In questionnaires, 56 respondents which is equivalent to 64.3% were strongly agreeing on that matter while during the interview discussions, the views of the respondents is that loans from banks do not assist SME but often discriminate against SMEs because they are considered “high risk” clients with little or no resources to provide collateral. As on the issue of interest rate imposed by Banks on loans provided, respondents referred as too high to be afforded by SME’s in Zanzibar. According to these respondents, it is difficult to prosper with loan payment which attracts such high interest rates. For instance, real interest rates on loans can go beyond 25 per cent, and all commercial banks operate around that range of interest rate. Business owners complain about the inflexibility of banks in enforcing onerous collateral requirements for any credit they extend.

This is a major obstacle for SMEs development in Zanzibar. For instance, response from the Zanzibar National Chamber of Commerce (ZNCCIA) as the private sector apex organization in Zanzibar explains that SMEs in Zanzibar remain handicapped by the fact that most financial institutions are ill equipped to serve the SME sector. Owing to lack of adequate funds to employ qualified personnel; such institutions appear to have serious internal management weaknesses and unqualified staff, leading to the poor quality of the services provided.

ZNCCIA further elaborated that the human resources of the financial institutions are inadequate both in number and quality. Most staff lack experience and motivation. As these institutions are short of internal resources, they cannot recruit skilled manpower, train staff and pay reasonable salaries to prepare their personnel to be creative in dealing with SMEs and their demand for finance.

There has been lack of record keeping and reliable data as observed by the researcher in this study. Throughout the interview discussions, respondents from different sectors

repeatedly mentioned lack of reliable data for deal valuation in loan requirement as one of their main challenges. 17 respondents which is equivalent to 19.3% believe that lack of record keeping and availability of reliable data for valuation has been unduly slowing down their investment process. Understandably, this problem is a societal issue with SMEs in Zanzibar because they have the culture of not keeping reliable data for effective deal of valuation. Another aspect of data gathering difficulty is the work of professional like auditors and accountant.

According to the respondents, the work done by these professionals is becoming a challenge to the smooth application of the concept of loan. Some of these professionals collaborate with owners of investee firms to concoct figures in their financial statements which seriously distort valuation results. They emphasized that the practice does not allow bankers to have a true view about their investee firms before valuation and therefore most of their valuation figures are inaccurate.

Financial assistance from government sources are largely misused as they are directed to certain sectors of society that are not supposed to benefit from such schemes. Some respondents argued that loans given to government employees and its agencies should be used to provide subsidies, improve infrastructure and aide proper communication to boost the SMEs in the country. Another constrains to development of SME's raised by respondents was the concentration of finance sources in urban areas. Due to vast distances between major cities and rural settlements, the delivery cost of credit schemes tends to be exorbitant, making them very expensive to implement.

This is certainly in Zanzibar where it has been observed that the vast majority of financial support schemes are concentrated in towns.

People's attitude towards government funding is mostly synonymous to grants, and as such does not encourage good repayment practices and therefore microfinance are not likely to be sustainable at Ward level, due to limited scope for growth as well as limited management capacities.

District level microfinance with branches at Ward level seems to be a more promising alternative. It is feared that encouragement of member's savings culture will not be internalized as they are mobilized to join microfinance to be able to access loans.

#### **4.2.13.6 Respondents Suggestions**

On the question of potential benefit of the venture capital visa vis other sources of financing SMEs in Zanzibar,

*Adequate Financial Institutions for SME's Support.* Respondents proposed to have adequate financial institutions apart from banks and IPO suggest that Venture Capital Organizations should be established to help SMEs on finance issue as Venture Capital is considered a reliable potential source of finance to SME development.

#### **4.2.13.7 Objective Three**

To analyse the compatibility of venture capital to Zanzibar SMEs environment.

Venture Capital as explained requires sharing of Capital and expertise and therefore sharing of ownership of the enterprise. However the findings during interview discovered that owners of investee firms in Zanzibar have an attitude problem in business control. Most SMEs in Zanzibar have started as sole proprietorships and therefore they are sometimes consumed with the usual mantra of "this business is mine" attitude in their

business operations, owners of investee firms usually do not understand the need to structure their businesses professionally by taking on board those who have capital and expertise. According to them, it becomes more challenging when entrepreneurs start thinking about possible share of control and power.

In most cases, there is no centralized information sharing system on financial sources. Each individual institution generally advertises only the services it provides. This is widely acknowledged in Zanzibar, where the lack of an information centre and appropriate channels constitutes a major handicap for the collection of relevant information for SME development.

In Zanzibar, there are several government initiatives, banks and NGOs involved in supporting SMEs, but the country lacks an effective co-ordination mechanism to centralize SMEs-related information. This was the observation from respondents from the institutions during the interview. They were therefore of the view that lack of this effective coordination on information on financial sources has greatly affected the development in Zanzibar as most of the entrepreneurs can hardly get access to existence of venture capitals. As such these entrepreneurs continue with traditional means of funding their businesses. Others also argued that risk attitude of entrepreneurs could best be assessed based on the individual entrepreneur's "risk appetite" and the levels they are ready to assume rather than the generalization of the entirety.

The respondents discussed on bureaucracy and its effect on the operations of SME's in Zanzibar during the process of accessing funds to financial institutions where there were also varied approaches. Some believe bureaucracy could not be a challenge to their

operations because the investment process is a highly specialized business operation and therefore it is surrounded with a lot of documentations.

That was revealed during the interview with institutions from the process of conceptualizing the fund to the time of getting other investors on board which involves due process and a lot of documentations. For example the signing of investors' agreement, shareholders agreement and term sheets are all processes that require careful analysis and due care. Again, the process of appointing a fund manager with requisite skills and experiences requires extensive background investigation. Respondents also stressed that the process of thinking through various investment decisions in other companies requires much time and documentation. Indeed, the benefit of all these due processes to all stakeholders is the reduction of perceived risks associated with investments. The sum of their arguments suggests that equity financing takes time and a lot of documentations.

Some of the respondents believe bureaucracy rather helps the process because it allows for careful assessment and reduction of investment risks. It is widely believed that a highly risky investment activity and therefore requires due diligence to ensure value for money investment. Obviously, this group of respondents strongly believes that bureaucracy in investments is good for all stakeholders in the SME industry in order to reduce its associated risks.

Concerns of lack of clear-cut policy direction retards real growth of the SME industry Avnimelech and Teubal, (2002) Murray (2007). Lack of clear-cut policies has led to the situation where they do not have recognized body with oversight responsibilities for the organizations. Obviously, the development of VC industry in countries such as the US, India and Israel speaks of concerted efforts in drafting effective policies in respective



countries, Dossani and Kenney (2002). VC is generally regarded as a specialized investment class that requires special policies and regulations.

Assessing the value of an SME would usually require quality information and therefore in an environment where record keeping is a problem, demonstrates how frustrating client valuation could be. Other respondents argued that poor record keeping could lead to bureaucratic tendencies and indirect costs in corruption. Lack of record keeping suggests to be a problem with developing world because the experiences from developed countries such as the US, Sweden and Israel suggests something to the contrary. They also described the effect of lack of research support for their operations as very hurting and inimical to the development of a vibrant VC industry in the country. This is due to the fact that VCs would usually need to commission private research about a particular industry before simple clients valuation could take place.

For the creation of a synergetic relationship among government, academic institutions, entrepreneurs and venture capitalists could help in providing reliable data for the industry. For that reason, respondents' request for government support for research.

#### **4.2.13.8 Respondents Suggestions**

On the objective of analysing the compatibility of venture capital to Zanzibar SMEs environment,

- **Entrepreneur Attitude on Control of Business**

They suggested that entrepreneurs should change their attitude on the issue of control of business and open mind to the issue of Venture Capitalist mode that will allow them to grow by getting full commitments to additional funding thus help in the possibility of growth of their businesses.

Also respondents suggested that *policies should be established to lead Venture Capital Fund*. The process of establishment of Venture Capital Fund should also consider having a body in place for oversight of the Fund.

## **CHAPTER FIVE**

### **5.0 SUMMARY, CONCLUSION AND RECOMMENDATION**

#### **5.1 Introduction**

This chapter draws a conclusion and recommendations of the study. The conclusions are based on the findings of the study, while the recommendations are the actions to be taken to improve access to finance in Zanzibar by establishing Venture Capital Organisation.

#### **5.2 Summary of the Main Findings**

This study has revealed that the venture capital has less effect to the SMEs in Zanzibar. The professional entities and different scholars have the common understanding that the in Zanzibar we had limited initiatives to strengthen Venture Capital towards improving SMEs. Different scholars explain that the countries that use venture capital experience were those whose economy grows significantly as referred in Henrick snyman (2012) financial loans offered by banks to which majority of SMEs can hardly access and even when accessing the same, they cannot manage to grow through such loans which have high collateral and high interest rate. Venture Capital has proven to be a better alternative to traditional sources of financing SMEs in the country (especially loans) as it has been justified in this study that the later has not significantly benefited the SMEs in Zanzibar.

In the study of Gakure, (2012) it was concluded that SME that use venture capital experience growth and therefore there is a need to strongly encourage Zanzibar SMEs to use this form of finance Gakure and Karanja (2012)

##### **5.2.1 Discussion**

In the course of this study, it has been revealed that most of Zanzibar SMEs are not aware of the venture capital. This has been justified with the great percentage of respondents who

explained that they are not aware about venture capital as a source of equity finance to SMEs. As provided in the findings, 84% of the respondents were not aware of venture capital as source of excess to finance small and medium enterprise, and therefore had no idea of such kind opportunities for the growth of their businesses. On the other hand, most of the SMEs and other respondents in this study were aware of other means of financing SMEs especially loans from banks and other financial institutions. About 64.3% of the respondents were aware of the loans from banks and other financial institutions but they said that loan provided from Banks were unfavourable to SMEs.

As this study has been conducted in Urban West Region which is the main urban city of Zanzibar where traditionally it is expected that residents of towns are normally more aware of emerging issues and development than their fellows in up country or villages, it raises suspicions that the venture capital could be a very strange creature if the study is done in the whole of Zanzibar.

Despite the fact that this study has revealed that the majority of SMEs in Zanzibar are not aware of venture capital, yet during discussion of the same, the respondents after being enlightened on how the venture capital operates, were of the view that it has potential in the growth of SMEs in the country. About 64.3% of the respondents were of that view that venture capital is potential in bringing impact to the growth of SMEs in Zanzibar. This is quite a significant percentage which proves that, with education and support on SMEs through venture capital, the response could be impressive.

The views of respondents on the potential of venture capital in financing SMEs as opposed to other sources of financing is justified with the views of different scholars who conducted

studies in similar or related subject. Memba, Gakure and Karanja (2012) prove that there has been a significant growth of SMEs firms when they engaged in venture capital. They provided facts towards establishing that most of the firms which engaged in venture capital doubled their sales and capital when engaged venture capital comparing to when they were not involved in venture capital. Also they argued that such growth of SMEs who were involved in venture capital had significant contribution towards the growth of Kenya economy.

Oscar, Elias and Lucio (2011) though did not directly look at venture capital, but they have done a lot of research to reveal the main challenges facing SMEs in accessing loans and its respective complications especially rates of interest to SMEs. They argued that in Europe, there is a great challenge of the gap between interest rate imposed to between SMEs and large scale businesses. They further argued that this difference in interest has even lower the efficiency of the SMEs. This proves that the venture capital could be potential in financing SMEs as opposed to loans which have proved to attract more challenges in financing SMEs as cited these scholars.

Manyani (2014) has overemphasised on the issue of access to finance as the key determining factor towards the development and growth of SMEs. The finance, he asserts, could be used in investing in innovation, restructuring and qualification. However, the author's views prove that the SMEs hardly access finances from banks because of several reasons including failure to provide financial guarantees before getting the loans.

This view is in the same line with the findings of this study that traditional sources of financing SMEs especially loan is not very effective in financing SMEs and therefore

majority of the respondents preferred venture capital as opposed to loans from banks and other financial institutions.

Education on venture capital is emphasized as the study has also proved that there has been an attitude of fear among SMEs that inviting other companies to invest in their businesses through capital financing as well as management of such business, could affect the ownership of their respective businesses. But as found through this study, once the SMEs get to know about how venture capital operates and its impacts towards their businesses, the SMEs support this concept. This fact is also justified by the relatively high response of SMEs towards grants provided through Business Development Gateway (BDG), where the two governments in Tanzania were providing both financial and managerial support to SMEs through trainings in how to conduct businesses efficiently. As shown in this study, the number of applicants for the support was relatively higher than the available funds for the same.

### **5.3 Conclusion**

#### **5.3.1 Public and Private Sector Participations (PPP)**

The Growing Importance of Public Sector Involvement Financial risk-taking is likely to speed up the pace of innovation. But what is the role of public and private capital in financing business and how should public initiatives interact with private sector efforts?

In many countries, venture capital has been perceived as a merely private sector domain. Public sectors have hitherto only played a limited role. But along with a growing recognition of venture capital as fuel for successful entrepreneurship, private venture capitalists are great concern to policymakers in terms of how it might worsen overall growth prospects. There is no doubt that governments should play a key role in improving

access to finance in Zanzibar. SME's cannot develop by the assistance of the private actors alone.

Despite significant public involvement, the role played so far by governments is highly controversial. In Zanzibar there is no efficient means to assist in developing venture capital industries. There is an important need for government to reflect aspect of venture capital in its planning but from the findings of this research fewer efforts have been undertaken to achieve the goal of having strengthened venture capital. The public sector plays a role in supporting and fostering technical progress.

At the same time, it should be able to identify market failures in order to justify intervention, including in venture capital markets. Hence, to be efficient in policymaking, governments must ask questions such as: in which ways are various policies hindering or enabling venture capital activity, why should it intervene in venture capital markets, which market or policy distortions are best left alone or worth addressing, and what ways are most effective.

In most countries, public sectors have been specially commissioned to channel funds to entrepreneurs, and especially to early stages of company development and commercialisation of new technology-based products. These factors generally include specific funds, agencies and institutes. Governments also play other more indirect roles in support of SME's, such as through regulatory measure as this is important for public-private partnerships. The role of public investors varies greatly between countries, however. The extents to which their strategies are compatible with, and conducive to, functioning for the improvement of SME's also vary in Zanzibar. Although there has been

a support from government to support SME's, yet there is no comprehensive mechanism to support SME's as very little is available to SME's due to limited budget with greater number of SME's.

#### **5.4 Recommendations**

The objectives of this research are to examine level of awareness of Zanzibar SME's and on how potential could be in financing Zanzibar SME's. But also to investigate how potential venture capital could be in financing SME's in Zanzibar. Venture capital activity entails opportunities to restructure entrepreneurship business and respond to growing transnational demands, for that we suggest to the below icons on what to be done for the development of SME's in general by:-

- a. Create awareness of the Zanzibar SMEs towards venture capital financing. It is preferable that the 'skill improvement' effect of venture capital was a significant additional benefit to Zanzibar SME's
- b. This study suggests and recommends that the key driver of such distinctive performance is the management support offered by venture c
- c. Capitalists Organisation to their portfolio SMEs. In that case, the Zanzibar Government should make effort to initiate venture capital organisation.
- d. In order to complement government's efforts and realize the objective of revamping SMEs promoters and entrepreneurs should brace up to the challenges posed by the environment. The SMEs should maintain quality in their goods and services and ensure quality control in all production activities at all levels.
- e. SMEs should honour payment obligations to banks, government or other grant/loan agencies.



- f. SMEs should provide needed statistics and information to relevant agencies whose contributions are vital to creating and sustaining an enabling environment.

SMEs should inculcate the habit of training and developing their management and staff in order to build capacity for meeting the challenges of the time and embrace and take advantage of developments in information and telecommunications technology and other technological areas.

### **5.3.1 Government Institutions**

The Government of Zanzibar should promote venture capital in the country. It has good reason to reflect on how to embark on reforms in order to do away with costly rigidities and barriers in the countries, and on how to support better driving forces in collaboration with the Private Sector for the development of our economy. Zanzibar should allow venture capitalists to play a more constructive role in the local governments in the development processes. Concurrently, the conditions restraining entrepreneurship also need to be addressed.

### **5.3.3 Private Sector**

Private Sector and relatively small domestic markets may grow if they welcome collaboration initiatives from bigger firms with technical and financial support and ultimately bring reforms that improve openness and learning. Private businesses from other countries improved mechanisms for the provision of seed and venture capital.

### **5.3.4 Private Public Partnership**

Zanzibar Public and Private sectors should take in to account the mechanisms and means for such adaptation. Despite the tendency towards a measure of global convergence in today's business development

#### **5.4 Areas for Further Research**

Based on this study where the researcher has analysed the impact of the venture capital to the SMEs in Zanzibar, there are more areas for further research which could build upon this study. Those areas include:

- 1) The Impact of venture capital to the Zanzibar economy. This study will look on how the venture capital could bring impact to the entire economy of the country as opposed to this study which has been confined on the impact of venture capital to SMEs growth only.
- 2) The Challenges in Establishment and Development of Venture Capital in Zanzibar. As it has been revealed that there is a potential in venture capital bringing impact to the growth of Zanzibar SMEs in the study conducted, this new study will look on challenges which might be faced in establishing and developing venture capital and possibly how to address such challenges.

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## APPENDICES

### Appendix 1 – Data Collection Tool on SME's

#### **SECTION A: DEMOGRAPHIC INFORMATION**

A1. Gender.....

A2. How old are you .....

A3. Level of education.....

A4. How many number of years worked in the enterprise .....

A5. What is your marital status? .....

A6. What is the total number of employees in your department?

A, during establishment.....

B. Current situation .....

#### **SECTION B: SME's INFORMATION**

B1. What type of your business operates?

Company.....a, Sole proprietorship.....b, Partnership.....d

B2. In what sector is the Business operating.....

B3. What internal factors do you perceive as hampering the growth of your business?

	<b>Great extent</b>	<b>Moderate extent</b>	<b>Not at all</b>
Access to Capital			
Government Policy			
Communication			
Loan requirements			

B4. Do you have any growth strategy planned during this period? Yes...1 No....2

B5. In what ways have investments been financed?

Grants ...a, Loan from Bank ....b, Family business....c, Issuing Share.....d

B6. Have you heard about Venture Capital Finance? Yes....1 No ....2

B7. Was there any problem for you to receive other source of finance your Business like Venture Capital Finance? Yes.....1 No.....2

B8. Does your firm is aware of venture Capital as a significant source of financing?

	<b>Agree</b>	<b>Disagree</b>
venture Capital as a significant source of financing		

## **Appendix 2: In-depth Interview Questions**

1. Are the Zanzibar SME's aware of venture Capital as a significant source of financing?
2. What is the potential of venture capital in Zanzibar SMEs development?
3. What is the feasible mechanism of moving to venture capital?
4. What's your recommendation in the growth of Zanzibar SME's?